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Public pension funds are a ticking time bomb

Government employee unions make the road to reform a difficult one—at best

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You probably know about the troubles with Social Security. But there's another retirement system in trouble: public employee pensions. A combination of too many promises and too little funding, fostered by political tradeoffs, has left many state and local governments in a precarious position.

In 2005, Stateline.org declared "Pensions pose time bombs for budgets." Last month, USA Today noted that, at the federal level, the unfunded pension obligations for civilian employees and military personnel ($4.7 trillion) exceed the unfunded liability for Social Security ($4.6 trillion).

In January, the Wisconsin Policy Research Institute (http://www.wpri.org) put the amount of unfunded state obligations at $340 billion nationwide. In Illinois, one Chicago Democrat lamented "In coming years, we will have an unbearable burden for money we owe to the pension systems."

Private companies may foist their obligations on the Pension Benefit Guarantee Corp. But there is no "out" for lawmakers or for taxpayers. So meeting pension obligations will mean tax increases, less money for other government purposes, or both.

Unfortunately, the road to reform is blocked, or at least made much more difficult, by the political power of public employee unions. It's a classic problem from economic theory. The costs of public pensions are hidden in the cost of government, dispersed among the members of an unorganized public, each of whom pays only a portion of the pension. The benefits, meanwhile, are easily identifiable and concentrated in a relative small group of highly motivated and politically organized employees.

Governor Arnold Schwarzenegger (R-Calif.) learned about the power of public sector unions. After his reform proposals were soundly defeated at the polls with the help of union activism, he changed his political stripes. Nationally, the powerful public union AFSCME argues that little needs to change.

How did we get into this mess anyway?

Budget trickery is one source of the increase. Like a homeowner who skips payments and then refinances the mortgage, the state government of Washington (among others) skipped several required payments as a cost-savings measure. The missed payments (and the missed investment returns) were rolled into ongoing actuarial assumptions.

The Evergreen Freedom Foundation (http://www.effwa.org) says these steps contributed to a dramatic increase in unfunded liabilities for Washington state's two major public pension plans. In 2000, the unfunded liability was $778 million. That gap rose eight-fold to $6.4 billion in 2005.

States have argued that the 2001 recession did them in. True enough, declining tax receipts and investment returns made their work more difficult.

But too often, they did not take full advantage of dot-com boom. Thank, or blame, gain-sharing.

Here's how it works. Say that a pension plan assumes an average annual return of 7 percent on investments.

What happens if a recession hits and returns are only 5 percent? The fund is in a hole, and needs above-expected returns in other years to make up the difference.

But under gain-sharing, only some of the surplus in good years goes into the fund. The rest goes, not to shore up the plan, but to send bonus checks to current employees. An even more precarious practice is to permanently increase the public obligation to employees. Under gain-sharing, taxpayers are obligated for shortfalls, but do not enjoy all the benefits of surpluses. That's just wrong.

Political dynamics go a long way to explaining current shortfalls. John Moorlach, an Orange County, Calif., supervisor, blames a peace-now, pay-later mentality. "Elected officials love to give generous retirement benefits because they don't cost anything today, and they'll be out of office when the payments come due." What about the public? Eyes droop with boredom when you bring up the topic.

Where to Go?

I'm not optimistic about the prospects for meaningful reform. As the Wisconsin Policy Research Institute says, the politics of government undermine the business of government. The politics won't change anytime soon. The primary responsibility of government employee unions is not to be concerned about the public purse, but that of its members. They resist making changes for *new* employees.

That said, elected officials need to make several changes, as political and legal considerations allow.

First, move to a defined contribution system, which is used by 80 percent of private sector employees, but only 18 percent of public employees. Union leaders know these plans put some risk on the employees, which is one reason they oppose them. But they make sense in an age of mobility.

Second, stop gain-sharing. Even AFSCME says that “governments should avoid providing benefit increases based on plan ‘overfunding’ or ‘excess assets.’”

Third, align plan specifics with private sector practices. Press accounts are rife with stories of public employees gaming the system. It’s understandable why employees would do that. But that is no defense for public managers not doing something to put a stop to it.

Government needs workers. That’s obvious. So too is this sad fact: the public is going to pay dearly for the mistakes of the past.